



# **Helping Charities, Sustaining Foundations:**

**Reasonable Tax Reform Would Aid America's Charities,  
Preserve Foundation Perpetuity and  
Enhance Foundation Effectiveness and Efficiency**

**NCRP's Analysis of Sec. 105, Reform of Certain Excise Taxes Related  
To Private Foundations, of H.R. 7, the Charitable Giving Act of 2003**

**June 2, 2003**



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**National Committee for Responsive Philanthropy**

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About NCRP:

Founded in 1976, the National Committee for Responsive Philanthropy (NCRP) is dedicated to helping the philanthropic community advance the traditional values of social and economic justice for all Americans. Committed to helping funders more effectively serve the most disadvantaged Americans, NCRP is a national watchdog, research and advocacy organization that promotes public accountability and accessibility among foundations, corporate grantmakers, individual donors and workplace giving programs.

For more information on NCRP or to join, please visit [www.ncrp.org](http://www.ncrp.org) or call (202) 387-9177.

## **Introduction**

The National Committee for Responsive Philanthropy has analyzed IRS data on private foundations to assess the effect of **Sec. 105 — Reform of Certain Excise Taxes Related to Private Foundations**, contained in **H.R. 7 - The Charitable Giving Act of 2003**, on the foundation community.

**After reviewing the results of this analysis, as well as the work of other researchers, NCRP strongly encourages the U.S. House of Representatives to retain the language in Sec. 105 of H.R. 7 that would have private foundations exclude operating and administrative expenses from their annual grants spending calculation, currently set at 5 percent of foundation noncharitable use assets. The measure would ensure that private foundations simply direct that full 5 percent toward grants. NCRP estimates that this reasonable tax reform provision could boost grantmaking to America's charities by up to \$4.3 billion annually, while safeguarding the perpetuity of the nation's private foundations.**

We do, however, acknowledge that foundations have legitimate concerns regarding this provision, many of which we share and address in this report. Like the leadership of many foundations, we believe that an additional \$4.3 billion in foundation grants cannot and should not be expected to re-knit the nation's tattered social safety net. But those additional grant dollars from private foundations can do a great deal to bolster the strength of the nation's nonprofit sector and increase the abilities of nonprofits to advocate for social change and experiment with models of programs demonstrating innovative and productive ways to address our nation's problems. At the same time, nonprofits need to recognize that additional foundation grantmaking is not a panacea for their sector. They still have to advocate for more foundation support for grassroots organizations, more grantmaking attention to critical social issues, more foundation support for nonprofit core operating costs, and more foundation engagement in public policy advocacy for social change.

Under current law, the "qualifying distributions" that foundations use to meet their required minimum payout of 5 percent may include their grantmaking *and* a variety of other administrative and operating costs. Public foundations and public charities do not face this spending requirement and would not be affected by the changes in Sec. 105 of H.R. 7. The proposed change in the law contained in Sec. 105 would prevent foundations from including any administrative expenses in their 5 percent payouts. Expenses related to salaries, board compensation and honoraria, employee pension plans, travel and meetings, rental and occupancy costs, printing and publications, professional fees, taxes, and depreciation would no longer count toward payout. Foundation excise taxes, however, would still be an allowable deduction against a foundation's "distributable amount," which the qualifying distribution number is based on. By our interpretation, program related investments (PRIs), which are tantamount to loans or recoverable grants from foundations, would still count toward a foundation's qualifying distribution.

Beyond the beneficial impacts for charities and foundations of the proposed reform in how qualifying distributions are calculated, Sec. 105 would also give foundations a tax break they have long sought: It would reduce and simplify the private foundation excise tax from 2 percent to 1 percent. While the provision does not specify what that public revenue should be used for, NCRP suggests that it would most appropriately be used to enhance IRS oversight of

foundations, which has reached historic lows at a time when foundations are more numerous than ever.

### **NCRP's Analysis**

NCRP has taken to heart many concerns and apprehensions about the implications of a legislative change related to the composition of private foundations' qualifying distributions. Nevertheless, NCRP sees substantial merit in excluding administrative and operating costs from private foundation payout for the following reasons:

- **The nonprofit sector, and the disadvantaged Americans it strives to serve and represent, face a high level of need.** Especially in this era of evaporated government surpluses at the state and national levels; high levels of unemployment; and increased demands for nonprofit and government social services, we believe that the foundation community has a duty to fully and honestly fulfill its charitable mission of supporting nonprofit organizations. Foundation grantmaking is best viewed as the "risk capital" for social change, as one national foundation sector leader frequently puts it. Social change is best accomplished by investing that risk capital in our nation's nonprofits — the front line of social change in our society. We do not believe that devoting a substantial and largely unregulated portion of foundation "payout" to internal foundation operations instead of nonprofit organizations realizes this important foundation mission. Changing the composition of qualifying distributions would clearly induce higher levels of foundation grantmaking, getting money into the budgets of nonprofits that serve on the front lines of addressing social and public issues.

According to an IRS analysis of private nonoperating foundations in 1999, more than \$2 billion in operating and administrative costs was included in total foundation payout that year — the last in which the IRS conducted such an analysis. In 1999, these 58,840 foundations made \$22.3 billion in grants, while total qualifying distributions that year reached \$25.1 billion. More recent data for 2001 from the National Center for Charitable Statistics at the Urban Institute suggest that administrative and operating expenses included in foundation payout could be closer to \$4.3 billion. Although the \$2 billion spent in 1999 on operating and administrative expenses was just 8.7 percent of total foundation charitable expenses, it is important to keep in mind that the average foundation grant to a nonprofit organization is just \$134,000, based on data from the 2003 edition of the Foundation Center's *Foundation Giving Trends*.<sup>1</sup> If in 1999, foundations were not allowed to include these costs in their payout calculations (and holding all other factors constant), up to 15,000 additional average-sized grants could have been made to the nation's nonprofit sector.<sup>2</sup>

To understand better what these substantial charitable administrative expenses are used for, NCRP analyzed the top 100 grantmaking foundations in the United States, based on data from the National Center for Charitable Statistics. In 2001, these foundations spent **\$9.2 billion** on

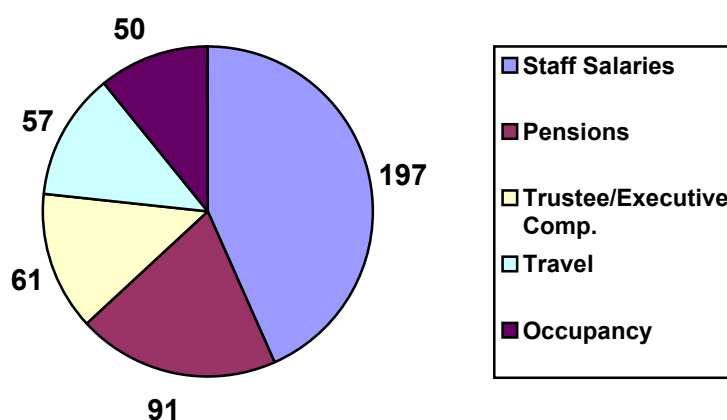
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<sup>1</sup> The Foundation Center's statistics are based on a sample of 124,844 grants of \$10,000 or more awarded by 1,007 larger foundations.

<sup>2</sup> The median size of foundation grants in this sample is even smaller than the \$134,000 average cited above, at \$30,000, meaning that the value of half of all foundation grants awarded in this sample was less than \$30,000. Grassroots groups, especially, are more likely to be applying for smaller grants, which, it should be noted, often take nearly as much time and effort as applying for a larger grant.

“charitable purposes.” Within this sum, \$883 million was spent on operating and administrative costs to carry out the foundations’ charitable mission (i.e., grantmaking). In other words, 9.6 percent of these 100 foundations’ charitable purpose expenditures were spent on operating and administrative expenses. The average foundation in this sample devoted 8.2 percent of its total charitable-purpose expenditures to operating and administrative costs, while the median foundation spent 4.5 percent.

More than half of these payout-related administrative and operating expenses (\$456 million) were devoted to trustee fees, executive compensation, staff salaries and pensions, travel expenses, and rent and mortgage fees. The remaining \$427 million in operating and administrative costs counting toward payout was divided among expenses related to printing and publications, professional fees, taxes and a catch-all “other” category. The following graph illustrates the breakdown of this \$456 million in operating and administrative expenses that counted toward payout (figures are in millions of dollars):



The three compensation categories above — staff salaries, trustee/executive compensation and pensions — total nearly \$350 million, all of which is included in these 100 foundations’ payout calculations.

It is important to remember that the \$883 million in operating and administrative expenses that was counted toward payout does not represent total operating and administrative expenses for these top foundations. In 2001, payout-related operating and administrative costs represented 62 percent of total foundation operating and administrative expenses for these foundations. Some foundations consider nearly all of their operating and administrative expenses as counting toward payout, while others count hardly any of these expenditures as such.

The line items of most interest to us — related to compensation, travel and rental expenses — were all largely counted as payout expenses. In particular, 89 percent of occupancy expenses, 68 percent of travel expenses and 63 percent of total compensation expenses were counted toward these 100 foundations’ payout rates.

- **Removing operating and administrative costs from qualifying distributions would be a manageable cost for most foundations.** If private foundations were no longer able to include their operating and administrative costs in their annual payout, their costs would certainly increase to some extent. But consider the IRS estimate that operating expenses make up 8.7

percent of total nonoperating private foundation payout. If foundations excluded their operating and administrative costs from their payout rate, paid out 5 percent of assets in all grants and maintained all other expenditures at their current levels, their annual expenditures as a percent of assets would increase a **mere four-tenths of one percent** (.4 percent).

- **Foundations would be motivated to increase their spending efficiency.** Although IRS data suggest that removing foundation operating and administrative costs from their payout would be only a minor financial burden, some foundations claim that the increased expenses would erode their asset bases and jeopardize their organizational perpetuity. Any reasonable analysis of the data would refute this claim (as will be discussed shortly). But if foundations are truly concerned about their longevity, excluding operating and administrative costs from their payouts would be a very strong incentive for foundations to rein in exorbitant expenses related to board and executive compensation packages, travel and office rental, and occupancy costs. *It is important to point out that the proposed legislation would not legally require foundations to spend less on their operating and administrative costs — it would simply prevent foundations from counting these expenses as something charitable.* Foundations are free to spend whatever they deem appropriate on professional services, salaries, travel, rent, etc.; the proposed legislation would merely add an incentive to approach that spending efficiently.

- **Self-regulation of foundation administrative expenditures is not working.** The Council on Foundations and its members have long claimed that strict government oversight of the foundation community's administrative and operating expenditures is unnecessary, citing the seemingly high ethical standards within the community and its leadership. However, several scandals involving foundations seen as sector leaders, as well as the rapid growth of the foundation community (the number of foundations and their assets both nearly doubled in the 1990s), suggest that self-regulation is insufficient, especially with the minimal oversight the IRS currently provides.

This need is especially evident in two recent cases of apparently questionable, excessive administrative expenditures. The cases received wide press coverage, but were not exposed, much less “prosecuted” by, national philanthropic organizations or the IRS. The first case, in California, surfaced when a foundation employee revealed information to the press concerning the apparent excess compensation and perks received by the foundation's former president. The second example, in Houston, came to the public's attention because a disgruntled relative of the foundation's CEO brought information to the state attorney general's attention. In that instance, the foundation's CEO “earned” \$935,000 in 2001 and the foundation's secretary received \$395,000, while total grantmaking was only \$1.8 million. *The government and foundation sector had nothing to do with uncovering these scandals.*

Sec. 105 of H.R. 7 also simplifies and reduces the foundation excise tax from 2 percent to 1 percent. NCRP strongly endorses this proposed reduction of the foundation excise tax. It has long recommended, however, that revenue from the tax be used to enhance public sector oversight of the foundation community and improve monitoring, data collection and service to the nonprofit sector overall. Currently, the budget of the oversight section of the tax-exempt division of the IRS allows for audits of only .002 percent of all registered private foundations in an average year. NCRP has long been the leading organization promoting a better-resourced tax-exempt division in the IRS, which would result in more consistent oversight and enforcement. In the wake of the recent press exposé of alleged misspending by a West Coast foundation, NCRP

has been pleased to hear that some foundation leaders are beginning to come around on this issue. Ethical, capable, truly philanthropic foundations have nothing to fear from a stronger IRS role in this sector. Combining improved oversight with the removal of the incentive to put all foundation administrative and operating expenses into qualifying distributions is a recipe for greater philanthropic productivity, accountability and nonprofit benefit.

In fact, while NCRP strongly believes in linking the private foundation excise tax to bolstering the kind of public oversight that has clearly been lacking, the problem remains of what standards might be enforced to deal with these obvious scandals and others lurking behind the scenes, lacking the whistle-blowers that brought the California and Texas cases to the forefront. When most nonprofits mispend, their funders, constituents and customers can express their displeasure with the organizations' misbehavior. With thin regulatory standards in the repertoire of public oversight of foundations, comparable checks and balances on the behavior of foundations are largely missing. The accountability standards promulgated by the Council on Foundations are really just guidelines lacking specificity or rigorous enforceability.

Changing the composition of qualifying distributions to exclude administrative and operating costs is not the blunt instrument some fear. The alternative is to have a fine-grained government review of the charitable content of all foundation administrative and operating costs. This approach would hugely ratchet up government intervention in the day-to-day operations of foundations, resulting in considerable foundation expenditures in simply trying to track, allocate and justify costs. In fact, this was tried in a provision called the ".65 rule" in the mid-1980s, requiring foundations to distinguish between and allocate charitable and noncharitable administrative expenditures and then limit those expenditures to a small proportion of foundation payout. A 1990 government analysis revealed that the rule was subject to widespread compliance and reporting problems. It also found that nearly all the foundations in the study sample got it wrong, allocating either too much or too little of their administrative expenditures to one category or another. In 1991, the .65 provision and the concomitant limitation on administrative expenses were abandoned as unworkable. Unless a more robust and verifiable accounting regimen is devised to distinguish foundation expenditures on charitable programs from other foundation administrative and operating costs, the more effective and efficient solution is to simplify the required 5 percent foundation payout expenditures so that they are made up entirely of grants.

- **Measuring foundation performance and effectiveness lacks consistency and transparency.** Although most do not, some foundations already exclude their administrative costs from their payout calculations. Others count a percentage of their administrative costs as charitable. Because of this inconsistency, it is difficult to compare the activities of one foundation with those of another. Regulating, assessing and understanding foundation activities would be more transparent if all foundations were required to treat their payout calculations equally. As an example, when we began collecting data to analyze the legislation under question, NCRP collected or reviewed data from the IRS, the National Center for Charitable Statistics, the Foundation Center, and the actual IRS filings of private foundations. Based on these sources, we computed payout rates that ranged from 4.9 percent to 7.3 percent.

This lack of consistency is frustrating and troubling. Converting payout to all grants puts the assessment of foundations on an equal footing, comparing apples with apples—or grants with



grants—rather than making one foundation’s administrative expenditures the charitable equivalent of another foundation’s provision of grants.

It is already difficult for the average person to evaluate the effectiveness of a particular foundation. Foundations are required to file a Form 990-PF with the IRS, but this filing is a financial accounting of the foundation’s activities and sheds little if any light on the foundation’s programs, effectiveness or grantmaking policies. And unless a person understands how to read a Form 990-PF, he or she would even be unable to evaluate a foundation’s financial performance accurately. Making payout all grants would be one step toward improving foundation accountability and transparency.

**Philanthropy cannot fill the gaps in government assistance.** This legislation should not be construed to mean that an increase in foundation grantmaking (by eliminating foundation operating and administrative costs from foundation payout) should be used to take the place of public sector resources and investment. It is impossible to expect that foundation grantmaking — or private charity overall — can or should make up for the reductions in critical government programs that have been enacted or are being proposed. For example, annual foundation giving totaled about \$26 billion in 2001, more than a quarter of which was directed toward educational institutions and programs. As a comparison, the federal government’s discretionary spending budget alone in 2001 was **\$350 billion**, which is still grossly insufficient for re-knitting holes in the social safety net or addressing other public investment shortfalls at the federal, state and local levels. Given these disparities, private philanthropy cannot substitute for public responsibility — but it can and should leverage its limited resources as effectively and efficiently as possible to help our nation’s nonprofits and the vulnerable Americans they serve.

The new money that would result from a shift to an all-grants formula for private foundation payout would be only a drop in the bucket addressing current fiscal shortfalls. But it would be a large and important increase in the resources available to nonprofits to do what they do best: to experiment with new approaches, techniques and policies for addressing the critical issues facing Americans today and in the future. Anyone who imagines, hopes or fears that this modest reform would stimulate enough new grantmaking to fill the shortfalls in government responsibilities to the needy will be grossly disappointed. Everyone who imagines that it will spur new grantmaking, potentially bolstering the important social change roles of the U.S. nonprofit sector, will have new resources worth requesting and organizing around.

### **Foundation Concerns and Fears about H.R. 7**

Some foundations have expressed important concerns regarding the effect of this provision of H.R. 7 on the foundation sector, and have been vigorously lobbying against it. NCRP has carefully considered these concerns, keeping in mind that most public issues do not lend themselves to quick, obvious panaceas, and such is the case with the issue of private foundation practices in grantmaking and administrative/operating expenditures.

- **Perpetuity.** Most foundations — although not all — have been established to exist indefinitely. These foundations claim that H.R. 7 will force them to drain their asset base to cover their administrative costs and maintain an all-grants payout, putting their longevity at risk.

Several studies suggest, however, that foundations can afford to spend more than the legally mandated minimum of 5 percent of their assets while safeguarding their longevity.

- A 1999 study by DeMarche Associates, Inc. — commissioned by none other than the Council on Foundations, the foundation industry trade association — concluded that foundations could have paid out 6.5 percent from 1950 to 1998 and would still have increased their assets by 24 percent.
- A June 2001 study by Akash Deep and Peter Frumkin, both of Harvard University, examined a sample of 290 of the largest foundations, from 1972 through 1996. They compared the foundations' rate of investment return on their assets with the foundations' payout rate. They found that, "as a group, the foundations in our sample have returned 7.62 percent annually on their assets, while paying out an average of 4.97 percent."

***Keep in mind that NCRP's analysis concluded that Sec. 105's proposed reform would modify foundation expenses by only .4 percent to 5.4 percent — well below the 6.5 percent level that the research sponsored by the foundation lobby itself has found to be sustainable.***

Analyses done 30 years ago regarding the "half-lives" of foundations — i.e., how long it would take expenditures (grants and administrative and operating costs) above foundations' returns on investments, taking into consideration the effect of inflation, to erode half of a foundation's assets — amounted to several decades. Since that time, foundation returns in the 1980s and 1990s have been substantial and inflation rates have plunged. Even the recent two- or three-year downturn in the market does not warrant expectations that foundation half-lives would even be an issue because of H.R. 7, not to mention other proposals for significantly higher payout rates that have been discussed over the years but are not being suggested here. Expectations, hopes, or fears that Sec. 105's mere exclusion of administrative and operating expenses from private foundations' qualifying distributions would put foundations out of business are unfounded.

- **The conservative agenda.** Some liberal and centrist foundations believe that this provision is a political maneuver by conservative lawmakers to "defund" the left and make philanthropy conservative. H.R. 7 was introduced by Republican Roy Blunt and Democrat Harold Ford, and it counts Gregory Meeks and Eleanor Holmes Norton among its nearly 70 cosponsors. NCRP firmly believes, therefore, that this is a bipartisan bill designed to pump more endowed capital into America's charities, regardless of their political values, in a more efficient, honest way. Further, progressive organizations have pushed for higher payout rates in the past. For example, a recent campaign to increase payout to 6 percent was led by the National Network of Grantmakers, which represents progressive social change foundations, with the new additional 1 percent being earmarked for social change grantmaking. For years, those organizations promoting higher foundation payout were "left-baited." Now, because of the cosponsorship of H.R. 7 by conservative members of Congress, supporters of changes in foundation spending rules are being "right-baited." But changes in the composition of private foundations' qualifying distributions are not a left or right wing issue. It is as though liberal opponents of NAFTA should be considered right wing because Pat Buchanan joined them in their opposition. The modest change in foundation expenditures that H.R. 7 would create is a matter of economics, not left- or right-wing political interpretation.

And based on data from the Foundation Center, foundation funding is hardly progressive now. In 2000, foundation grantmaking for civil rights and social action was only 1.5 percent of total

foundation grant dollars, and in 2001, the proportion devoted to civil rights and social action dropped precipitously: For community improvement and development, it was only 3.7 percent, down from almost 5 percent a few years before; affordable housing and housing for the homeless account for less than 2 percent of foundation grantmaking; for African-American organizations and causes, only 1.4 percent; for Latinos, only 1 percent; for Asian-American organizations and populations, only .4 percent; for Native Americans, only .5 percent; and for gay and lesbian Americans, only .1 percent. To claim that this bill would undo a progressive or liberal philanthropic agenda misconstrues the current priorities of philanthropic grantmaking by the nation's roughly 60,000 active grantmaking foundations — and the financial effect of this change in qualifying distributions on private foundations.

Given the provision's bipartisan support, and the fact that it would benefit charities of all political stripes as well as those that are utterly apolitical, this reform measure cannot accurately be cast as a political tool of either the left or the right. It is a balanced proposal that rises above partisan politics and would merely simplify foundation grantmaking to help charities and improve foundation effectiveness.

- **Large grants to large institutions?**

Some foundations argue that if they are required to make their payout rates consist of all grants, they will be forced to scale back on staff to save money and preserve their endowments, which will prevent them from investing in small, grassroots organizations. They will instead direct their grantmaking toward large grants for large institutions.

But this troubling trend is already under way, irrespective of any proposed alterations in the makeup of qualifying distributions. Once again, according to Foundation Center data, foundations already make many large grants to large institutions. According to the 2003 edition of *Foundation Giving Trends*, the number of grants of \$10 million or more jumped 640 percent over the past decade. Nearly half of all grant money awarded is for grants larger than \$1 million.<sup>3</sup> Further, 35 percent of all grant dollars were devoted to educational institutions, museums and hospitals.

Fears or threats that eliminating administrative and operating expenses from qualifying distributions will spark a wave of foundation grantmaking to large organizations, to the detriment of grassroots organizations, are invalid: Foundations are already moving in this direction on their own. It is an idle threat. Actually, with or without a change in private foundations' qualifying distributions, the nation's nonprofit sector has a strong case to bring to the public's attention about the importance of supporting the diversity of community-based nonprofits and the trend of many foundations' forsaking the needs of small, grassroots groups.

- **Some foundation administrative expenses directly benefit nonprofit organizations.** We acknowledge that some foundation administrative spending is of service to nonprofits, but we maintain that administrative spending is *not* the same as grants to nonprofits. Also, many foundations dump all of their administrative expenditures into qualifying distributions, including expenses of questionable or nonexistent charitable value.

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<sup>3</sup> Again, the Foundation Center's statistics are based on a sample of 124,844 grants of \$10,000 or more awarded by 1,007 larger foundations.

Although some foundation administrative expenses benefit nonprofits, NCRP believes that such expenses are not equivalent to grants to nonprofit organizations, from a public-benefit perspective. Further, it is too easy for foundations to count excessive and even unethical and illegal administrative expenses as charitable. Again, nothing in H.R. 7 prevents foundations from spending resources on administrative expenses that they believe are helpful and productive for nonprofits. But the nonprofit community's fundamental need at this time, in a troubled economy and an environment of social and political turbulence, is grant money in their budgets. As noted above, without a robust, enforceable, cost-effective regimen for distinguishing legitimate foundation program expenditures from operating and administrative expenditures, the clearer way to proceed is simply to change the qualifying distributions in foundation spending to something tantamount to an all-grants formula.

- **The operating foundation option.** Some foundations claim that they will be forced to convert to operating foundations — devoting most of their resources to foundation-managed programs — which have lower payout rates than nonoperating foundations. It is unclear, however, how many of the nation's nonoperating foundations could easily and legally make this conversion, since operating foundations are required to meet various income, asset and revenue tests. Conversions would most likely require significant staff changes (or at least intensive retraining) within foundations, since managing a direct-service program requires different skills than does grantmaking.

On a more philosophical level, if a massive conversion to operating foundations occurred within the sector, it would send a strong signal to the government, nonprofits and the public that foundations are more concerned with their institutional longevity than with supporting the nonprofit sector, which is why they were granted preferential tax treatments in the first place. Such an action would undoubtedly capture the attention of lawmakers, and further erode the already declining levels of public trust in the nonprofit sector.

## **Conclusion**

**Based on our analysis of existing data and research, NCRP believes that Congress should support Sec. 105 of H.R. 7. This provision has the potential to pump billions of dollars into America's charities, without placing a large or unreasonable burden on the nation's foundations. Indeed, the provision under consideration has significant potential to help make the foundation community much more efficient and accountable.**

**In short, the research suggests that the modest simplification of foundation expenditures proposed in Sec. 105 of H.R. 7 constitutes a balanced and reasonable tax reform that would help America's charities, offer foundations a tax break that they have long sought, safeguard foundation perpetuity and enhance foundations' long-term effectiveness and efficiency.**

# Helping Charities, Sustaining Foundations

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National Committee for Responsive Philanthropy



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